

Illinois Commerce Commission

Initial Brief
Of the Staff of the Illinois Commerce Commission

February 25, 2004

TABLE OF CONTENTS

I.	PROCEDURAL HISTORY	1
II.	BACKGROUND	2
III.	PUBLIC USE	5
IV.	PUBLIC CONVENIENCE AND NECESSITY.....	9
V.	REVENUE REQUIREMENTS	11
A.	Overview of Recommended Revenue Requirements	11
B.	Test Year	11
C.	Rate Base	11
1.	Uncontested Issues.....	11
a.	Cash Working Capital	12
b.	Accumulated Depreciation.....	12
c.	Waiver Request	13
d.	Comment on Financial Condition of Silverleaf	14
VI.	CAPITAL STRUCTURE AND RATE OF RETURN.....	14
A.	Overview	15
B.	Capital Structure	15
a.	Embedded Cost of Debt.....	17
b.	Cost of Common Equity	18
C.	Summary	21
VI.	RATE DESIGN	21
A.	Recommended Rates	21
B.	Alternate Individual Billing Proposed Rates	25

VII.	TARIFF TERMS AND CONDITIONS	27
A.	Proposed Tariffs	27
B.	Waiver of Water Meter Requirements.....	28
VIII.	CONCLUSION.....	29

STATE OF ILLINOIS

ILLINOIS COMMERCE COMMISSION

SilverLeaf Resorts, Inc.	:	
d/b/a Resort Utilities	:	
	:	01-0827
Application for a certificate of Public	:	
Convenience and Necessity to provide	:	
sanitary sewer service in LaSalle County,	:	
Mission Township, Illinois, and to construct,	:	
own, operate and maintain necessary	:	
sewer and sanitary sewer treatment	:	
facilities in connection with the provision	:	
of such service, pursuant to Section 8-406	:	
of the Illinois Public Utilities Act.	:	

INITIAL BRIEF

NOW COMES the Staff of the Illinois Commerce Commission ("Staff"), through its attorneys, and files its Initial Brief in the above-captioned proceeding.

I. PROCEDURAL HISTORY

Silverleaf Resorts, Inc. ("SRI" or the "Company") filed an Amended Verified Petition for Certificates of Public Convenience and Necessity ("Certificate") to provide water and sewer service to the Fox River Resort located in LaSalle County, Mission Township, Illinois, and to own, operate, and maintain the necessary water and sewer facilities in connection with the provision of such service, pursuant to Section 8-406 of the Illinois Public Utilities Act ("Act") on June 28, 2002. (220 ILCS 5/8-406) On December 20, 2001 the Company filed an Application for a Certificate of Public Convenience and Necessity to Provide Sanitary Sewer Service in LaSalle County, Mission Township, Illinois.

On May 10, 2002, the Company filed a Motion to Withdraw Verified Petition for Certificate of Public Convenience and Necessity accompanied with a Stipulation of

Undisputed Facts. In the Motion to Withdraw, SRI argued that it would not be providing sewer service to the general public. On May 22, 2002, the Staff filed a Response to the Motion to Withdraw indicating that it concurred with SRI's conclusion that the Company would not be providing sewer service to the general public and thus was not required to obtain a certificate of public convenience and necessity.

The matter came on for hearing before a duly authorized administrative law judge of the Commission at its offices in Springfield, Illinois on July 15, 2002. Evidence was taken, and at the conclusion of the hearing, the record was marked "Heard and Taken." A Proposed Order was issued and briefs on exception and reply briefs on exception were filed. On October 29, 2002, the Commission entered an Interim Order denying the Motion to Withdraw and Reopening the docket.

Testimony was filed by Matthew S. Ennis, Edward L. LaHart, Harry J. White, Jr., Robert G. Levy, and Julie Westmoreland on behalf of SRI. Mary H. Everson, William D. Marr, and Sheena Kight filed testimony on behalf of the Staff. An evidentiary hearing was held on February 9, 2004 after which the record was marked "Heard and Taken."

II. BACKGROUND

SRI is the developer of the Fox River Resort in LaSalle County, Mission Township. SRI is primarily engaged in the business of marketing and selling Vacation Intervals (commonly known as "timeshares"). (Staff Ex. 4.00, p. 3) SRI is the sole owner of the Fox River Resort. (Staff Ex. 4.00, p. 4) SRI is a Texas corporation. The Fox River Resort Club is an Illinois non-profit corporation and the Silverleaf Club is a Texas non-profit corporation. The Fox River Resort Club and the Silverleaf Club exist as separate legal entities from SRI. (Staff Ex. 4.00, p. 7)

Silverleaf Club is the master club that operates all of the local clubs at twelve resorts owned by SRI in the United States, including Fox River Resort Club. Silverleaf Club operates these local clubs as a single system, meaning monthly membership dues are set system-wide by Silverleaf Club to recover the average cost of operating all of the SRI timeshare resorts, including the costs of providing water and sewer service. Silverleaf Club operates Fox River Resort and the other SRI resorts on a system-wide basis, co-mingling monthly membership dues and pooling operating expenses, rather than operating each resort property on a stand-alone basis, because of the Bonus Time Program. Silverleaf Club issues timeshare owners monthly membership dues statements on behalf of Fox River Resort Club. The monthly membership dues are collected by Silverleaf Club under a master club agreement for the benefit of the Fox River Resort Club. (Staff Ex. 4.00, p. 13-14, 16-20) Thousand Trails members (RV campsite and cabin users) at the Fox River Resort are part of the Silverleaf Club. All membership dues collected from Thousand Trails members go to Silverleaf Club under the Master Club Agreement. (Staff Ex. 4.00, p. 13)

Each year, Silverleaf Club develops a system-wide budget for all SRI resorts, and sets monthly membership dues system-wide (not on a resort-by-resort basis). This budget is intended to cover all operating expenses, including utilities, of all of the SRI resorts. Common operating expenses are added to the combined operating expenses of the individual resorts to create the master budget for Silverleaf Club. The master budget is then used as the basis for overall financial planning of all the SRI resorts. (Staff Ex. 4.00, p. 14-19)

SRI's water and sewer systems were constructed at the Fox River Resort solely in support of, and are ancillary to, SRI's primary non-utility business as a timeshare

resort. SRI constructs and operates the water and sewer utility systems at its resorts where such utility service is not available from existing third party utilities. (SRI Ex. 6, p. 14) SRI constructed the water and sewer systems at the Fox River Resort because utility service was not available from any third party utilities. (Staff Ex. 4.00, pp. 3-4, 8)

In Illinois, SRI only provides water and sewer service to buildings and areas located within the geographic boundaries of the Fox River Resort. SRI is the sole owner of the Fox River Resort, and has no intention of transferring ownership of any part of the Fox River Resort to another entity. (See Stipulation of Undisputed Facts, filed May 10, 2002) The Fox River Resort is dedicated exclusively for use by Silverleaf Club members, with no usage by the general public permitted. SRI has no plans to provide water or sewer service to anyone outside of the Fox River Resort property or to any other entity. (SRI Ex. 1, p. 13) Fox River Resort does not have a separate real estate development associated with it. (Staff Ex. 4.00 pp. 4, 8-9)

The owner of a timeshare is entitled to occupy a particular timeshare unit at the Fox River Resort for a one-week annual or biennial vacation interval. A timeshare owner/purchaser acquires title to the interior of a designated timeshare unit on the Fox River Resort property. (SRI Ex. 4, p. 3-4) The right of occupancy does not give the timeshare owner any right of ownership to the contents of the timeshare unit. (SRI Ex. 7, p. 11) Outside of the designated one-week interval of the year to which their ownership right applies, the timeshare owner has no interest in their timeshare unit. (Staff Ex. 4.00, pp. 4-6, 9)

SRI and the timeshare owners have contracts regarding the provision of water and sewer services to the Fox River Resort. Under the timeshare owner's sales contract with SRI, utility service is included in the purchase of a timeshare unit and the

payment of monthly membership dues. The Contract for Sale (SRI Ex. 4, Sch. ELL-1, p. 3, #9) provides that utility expenses will be covered in the monthly membership dues paid to the Silverleaf Club, which the timeshare owner agrees to pay as a condition of purchase of their timeshare interest at the Fox River Resort. (Staff Ex. 4.00, p. 7-9)

III. PUBLIC USE

The Commission should review the facts regarding the operation of SRI at Fox River Resort and, with the benefit of a full and complete record, reconsider whether SRI operates as a public utility within the meaning of the Act. Section 3-105 of the Act defines "public utility" as any entity "that owns, controls, operates or manages within the State, directly or indirectly, *for public use*, any plant, equipment or property used or to be used for or in connection with, or owns or controls any franchise, license, permit or right to engage in (a) the production, storage, transmission, sale, delivery or furnishing of heat, cold, power, electricity, water, or light . . .; or (b) the disposal of sewerage."¹ (220 ILCS 5/3-105) (Emphasis added.) The pivotal issue in making the decision in this docket is the determination of whether SRI operates its facilities for the public use.

Subsequent to the entry of the Interim Order in the instant docket, the Commission addressed a similar issue in Docket No. 02-0781, Mancuso Investment Corporation ("Mancuso") (Order, Sept. 30, 2003). In that Order, the Commission stated that Illinois courts' decisions "have regarded the public use requirement as establishing the boundary between those services that this Commission will regulate and those services *of identical kind* that we will not regulate. That is, while all water and sewer

¹ The term "public utility" does not include water and sewer companies that are strictly "mutual concerns" as defined in Section 3-105 of the Act. Silverleaf Resorts does not contend that the services at Fox River Resort are being provided by a mutual concern.

services are essential to their users, only some water and sewer services – those in public use – will be regulated by us. Private water and sewer services may be subject to other regulatory constraints in the public interest (e.g., environmental regulation), but are left outside of our regulatory power.” (Docket No. 02-0781, Order p. 5) The Commission concluded that Mancuso is not a public water or sewer utility. (Id., at 9)

Mancuso owns and manages a mobile home park (“Park”), and within boundaries of the Park, owns and operates a water supply and distribution system (“water system”), and a wastewater collection and disposal system (“sewer system”). Id., at 1 The Park includes 150 lots owned by Mancuso and available for rent by persons with mobile homes, and 37 lots owned by a total of 27 other owners (“private lots”). Id., at 3. All private lots are for mobile home units, except for one permanent single-family residence and one commercial building. Mancuso’s water supply system serves all mobile home lots in the Park, whether owned by Mancuso or someone else. Mancuso’s sewage collection and disposal system serves Mancuso’s rental lots and 12 private lots within the Park. Id. Mancuso has never provided water or sewer service to any properties outside the Park, and has no intention to do so. Id.

Mancuso filed a request for a declaratory ruling that it is not a public utility, or in the alternative, a certificate of public convenience and necessity to operate as a public utility in Illinois. Mancuso contended that it was not a public utility because it does not operate its water or sewer facilities for public use. (Id., at 2) Mancuso emphasized that it provides water and sewer service only within the mobile home Park and only to its own tenants or to a limited number of unaffiliated owners of mobile home sites formerly owned by Mancuso (or its predecessors). In determining that Mancuso is not a public utility, the Commission relied upon the decisions in Highland Dairy Farms Co. v.

Helvetia Milk Condensing Co., 308 Ill. 294, 139 N.E. 418 (1923), and Mississippi River Fuel Corporation v. Commerce Commission, 1 Ill. 2d 509, 116 N.E.2d 394 (1955).

In Highland, a milk condensing company and a brewing company, constructed and operated a water system for the benefit of their businesses. They allowed several residences and other businesses to connect to that system, but did not allow to a dairy to connect to the system. The dairy sought to have the operators of the water system regulated as a public utility. The court stressed the following attributes of the water system operation: (1) there had been no public effort to procure customers for the water system; (2) applications for water service were discouraged and some applicants were denied service; (3) the water system was not constructed to provide universal access but was routed primarily for the general convenience of operators; and (4) the corporate charters of the operators did not include the corporate purpose of providing public utility water service. The court held that the water system, although identical in general function to a public water system, was constructed for private use and that the operators did not hold themselves out to be in the business of supplying the public with water. Therefore the water system was not operated for public use and the operators were not a public utility. Highland, at 298, 420.

In Mississippi River Fuel Corporation, the Illinois Supreme Court addressed the issue of whether the sale of natural gas to 23 industries in Illinois represents a public utility operation. Mississippi River Fuel Corporation, at 515, 397. The court found that the corporation had consistently and with great care confined its gas sales to specific and selected customers and had done no act to give the reasonable impression that it was holding itself out to serve gas to the public. Id., at 518, 399. The court stated “[t]he mere fact that the thing sold by a company is water or gas or electricity or telephone

service, such as are ordinarily sold by public utility companies, does not of itself render the seller a public utility.” Id., at 515, 398. The court found that Mississippi River Fuel Corporation was not a public utility.

SRI is similar to the companies the in Highland and Mississippi River Fuel Corporation cases in many aspects. SRI constructed and operates a water system for the benefit of their businesses. SRI’s system was not constructed to provide universal access but was routed to provide service within the resort. SRI confines its water service to specific and selected customers, and had done nothing to give the reasonable impression that it was holding itself as a provider of water or sewer service to the public.

SRI concurred with Staff Witness Marr’s conclusion that SRI is not operating as a public utility at Fox River Resort for the same reasons set forth in Mr. Marr’s October 22, 2003 prefiled rebuttal testimony and requested that the Commission enter an order finding that SRI is not operating as a public utility at Fox River Resort, given that the Commission has a more complete record to make a determination on this issue. (SRI Ex. 8, pp. 3, 4, 11)

Applying the principles and conclusions from Mancuso, to this docket, Staff submits that SRI’s water and sewer systems are not operated for the public use and thus SRI is not a public utility within the meaning of Section 3-105 of the Act. Like Mancuso, SRI’s water and sewer systems were constructed in support of and ancillary to SRI’s primary non-utility business – operating a timeshare resort. Unlike Mancuso SRI does not, and has indicated that it will not, offer any water or sewer services service to any property outside of the Fox River Resort. No facts have been raised in this docket which would lead to a concern that the time share owners are in need of the

regulatory protection of the Commission.

The short duration of the timeshare user's interest in the timeshare unit distinguishes the timeshare owner from the typical utility customer who occupies a unit and receives utility services over an extended period of time. A timeshare owner's occupancy, because it is brief and transient in nature, is more similar to a stay in a hotel than to a long-term occupation of a typical residential or commercial space. (Staff Ex. 4.00 at 4-6, 9) Timeshare owners receive water and sewer service as part of the contractual agreement with SRI for the purchase of the timeshare unit. Membership dues, which include the operating costs of utility service, are also provided for in the sales contract. (Staff Ex. 4.00 at 7-9)

It is Staff's understanding that the Missouri Public Service Commission has a similar concern that SRI may not be operating as a public utility there. The Missouri Staff advised SRI to file a petition to de-certificate the Timber Creek Resort utility system in Missouri because it serves only timeshare units and is not currently considered a public utility under the state's regulations. The Timber Creek Resort utility system does not serve any residential or commercial customers outside of the resort property. (Staff Ex. 4.00 at 8)

IV. PUBLIC CONVENIENCE AND NECESSITY

If the Commission finds that SRI is a public utility, SRI has met the requirements for a Certificate to provide water and sewer service to the Fox River Resort, pursuant to Section 8-406 of the Act. Section 8-406 of the Act requires that a utility demonstrate three criteria before being granted a Certificate. The three criteria are:

- (1) that the proposed construction is necessary to provide adequate, reliable, and efficient service to its customers and is the least-cost means

of satisfying the service needs of its customers;

(2) that the utility is capable of efficiently managing and supervising the construction process and has taken sufficient action to ensure adequate and efficient construction and supervision thereof; and

(3) that the utility is capable of financing the proposed construction without significant adverse financial consequences for the utility or its customers.

220 ILCS 5/8-406(b)(1)–(3).

The SRI facilities are necessary and SRI is currently providing adequate, reliable and efficient service to the Fox River Resort. The facilities are the least-cost means of providing the service. SRI is capable of efficiently managing and supervising the activities necessary to provide water and sewer service to the Fox River Resort. The public convenience and necessity require SRI's provision of water and sewer service to the Fox River Resort.

SRI's existing water and sewer facilities were designed and installed to meet the needs of the Fox River Resort. Those facilities currently serve, and are sufficient to continue serving, the Fox River Resort. (Staff Ex. 2.00 at 3-4) SRI's ownership and operation of the water and sewer facilities constitutes the least-cost means of satisfying the service needs of the Fox River Resort. It is most cost efficient for SRI, who already has facilities in place, to provide water and sewer service to the Fox River Resort. There does not appear to be any municipality or investor owned public utility that is willing or able to serve the Fox River Resort with water and sewer service. (Staff Ex. 2.00 at 4-5) SRI's water and sewer systems currently have the capacity to serve the Fox River Resort and the 246 timeshare units to be constructed by year 2005. (Staff Ex. 2.00 at 5-6)

SRI has constructed, owned, operated, and maintained four water and sewer systems that serve developments located in Texas; and SRI has constructed, owned, operated, and maintained three water and sewer systems that serve developments located in Missouri. SRI has the experience and skill to efficiently manage and supervise the activities necessary to provide water and sewer service to the Fox River Resort. (Staff Ex. 2.00 at 7-8)

V. REVENUE REQUIREMENTS

A. Overview of Recommended Revenue Requirements

Staff's proposed revenue requirement for Silverleaf's sewer operations is \$400,908. (Staff Ex. 1.0-S, Sch. 1.1-S, line 3) This is \$124,717 less than requested by Silverleaf in direct testimony.

Staff's proposed revenue requirement for Silverleaf's water operation is \$150,085. (Staff Ex. 1.0-W, Sch. 1.1-W, line 3) This is \$13,334 less than requested by Silverleaf in direct testimony.

Schedules that calculate these revenue requirements are described and presented in the direct testimony of Staff witness Everson. (Staff Staff Ex. 1.0) Silverleaf accepted the Staff's proposed revenue requirement for both the sewer and water operations. (SRI Ex. 8.0, p. 10, lines 10-11)

B. Test Year

Silverleaf used a 2000 test year. Staff, in its analysis, accepted the Company's use of a 2000 test year.

C. Rate Base

1. Uncontested Issues

a. Cash Working Capital

Staff witness Everson proposed an adjustment to cash working capital for both the sewer and water operations for non-cash items. The Company used the one-eighth method of calculating cash working capital. Staff's calculation of cash working capital differed from the Company's in that Staff's calculation begins with pre-tax operating expenses and is reduced by annual amortization of rate case expense and depreciation. The Company's methodology did not reduce pre-tax operating expense by the non-cash items of amortization and depreciation. (Staff Ex. 1.0, p. 7, lines 106-114) The Company accepted the cash working capital methodology proposed by Staff. (SRI Ex. 8, p. 10, lines 10-11)

b. Accumulated Depreciation

Staff witness Everson proposed an adjustment to the Company's balance of Accumulated Depreciation to correct an error in the Company's calculation. The Company had used an incorrect number of years in service for various plant items in its calculation of Accumulated Depreciation. The Company used straight line depreciation that calculates a single amount to be charged to expense and credited to Accumulated Depreciation for each year of the service life of an item or group of equipment. Because the Company calculated the number of years in service incorrectly, the amounts the Company credited to Accumulated Depreciation are incorrect. Staff's adjustment corrects the Company's net plant balance to original cost less Accumulated Depreciation for the number of years the utility plant has been in service. (Staff Ex. 1.0, pp. 7-8, lines 118-130) The Company accepted Staff's adjustment to the balance of Accumulated Depreciation proposed by Staff. (SRI Ex. 8, p. 10, lines 10-11)

c. Waiver Request

Staff witness Everson did not object to Silverleaf's request for a waiver of 83 Ill. Admin. Code sections 250.10 and 600.110. Section 250.10 requires all public utilities to maintain an office within the State of Illinois in which all books, accounts, papers, records and memoranda connected with their utility operation within Illinois are to be kept. Section 600.110 also requires public utilities to maintain an office within the State of Illinois in which all books, accounts, records will be kept and that all utility records will be made available for the Commission or staff for inspection. Section 5-106 of the Illinois Public Utilities Act requires that each public utility shall be liable for, and upon proper invoice from the Commission shall promptly reimburse the Commission for, the reasonable costs and expenses associated with the audit or inspection of any books, accounts, papers, records and memoranda kept outside the State. Staff witness Everson stated that she had no objection to the Commission granting Silverleaf's request for a waiver, provided that Silverleaf complies with Section 5-106 of the Illinois Public Utilities Act regarding reimbursement for expenses associated with the audit or inspection of records kept outside of the State of Illinois. (ICC Staff Ex. 1.0, pp. 8-9, lines 132-153)

Staff witness Everson recommended that the Company should follow the Uniform System Of Accounts for Water and Sewer utilities as required by 83 Ill. Adm. Code 605 and 650 and should follow 83 Ill. Adm. Code 615, Preservation of Records for Water Utilities. The Company should also file timely annual reports as required by Section 5-109 of the PUA (220 ILCS 5/5-109). (Staff Ex. 1.0, p. 9, lines 156-160) The Company did not contest this recommendation.

d. Comment on Financial Condition of Silverleaf

Staff witness Everson recommended that due to the uncertainty of Silverleaf Resort Inc.'s financial future, Silverleaf should be ordered to notify the Commission if it files for bankruptcy. Staff witness Everson noted that Silverleaf Resorts had financial problems in the test year and that those problems continued throughout 2002. On March 12, 2002, the Company's former independent auditors, Deloitte & Touche LLP, disclaimed an opinion on the consolidated balance sheet of the Company and its consolidated subsidiaries as of December 31, 2000 because of "...pervasive uncertainties regarding the Company's ability to continue as a going concern." (Silverleaf Resorts Inc. Form 10-K as of December 31, 2001). BDO Seidman's audit report for 2001 also contains an explanatory paragraph about the Company's ability to continue as a going concern. In response to data request MHE-3.15, which requested the 2002 annual report to shareholders or the 2002 Form 10K, the Company stated: "Incomplete as of 2/25/03, will update response and submit copies when available." The Company did not provide Staff witness Everson with the audited financial statements for 2002. The Company has however, filed its 2002 Form 10K with the SEC and provided Staff with a copy that includes the opinion of the Company's independent auditor that again included a paragraph discussing the "substantial doubt" that exists about the Company's ability to continue as a going concern. (Staff Ex. 1.0, p. 9-11, lines 164-186) Staff witness Everson stated that she thought her recommendation is necessary due to the "going concern" uncertainties of Silverleaf and its lack of history of operating a utility in the State of Illinois. The Company did not contest this recommendation.

VI CAPITAL STRUCTURE AND RATE OF RETURN

A. Overview

Two witnesses presented testimony regarding Silverleaf's cost of capital: Mr. Matthew S. Ennis presented capital structure and cost of common equity testimony on behalf of the Company (SRI Ex. 3) and Ms. Sheena Kight presented the Staff's testimony concerning Silverleaf's capital structure, cost of equity and overall cost of capital (Staff Exhibit 3.0). The Company agreed with Staff's recommended return on capital of 7.36%. (SRI Exhibit 4, Rebuttal Testimony of Edward L. Lahart, p. 11, lines 13-16; Staff Ex. 3.0, Sch. 3.01).

B. Capital Structure

Silverleaf proposed using a 100% equity capital structure, since Silverleaf Resorts' Utility Division and the Fox River Resort water and sewer systems at issue in this proceeding are wholly owned subsidiaries of Silverleaf Resorts, Inc. (SRI Exhibit 3, Direct Testimony of Matthew S. Ennis, pp. 4-5.) Staff witness Kight testified that Silverleaf's December 31, 2002 capital structure comprises 73.53% long-term debt and 26.47% common equity. Ms. Kight compared the Company's December 31, 2002 capital structure to industry standards and her samples. According to S&P, A-rated utilities with a business profile score of 3, should have a total debt to total capital ratio between 47.5% and 53.0%. Ms. Kight's Water and Utility samples that share a typical water company's implied A+ credit rating have mean total debt ratios of 53.06% and 53.24%, respectively. The corresponding standard deviations are 6.13% and 6.80%. Thus, Silverleaf's December 31, 2002 debt ratio is three or more standard deviations above the average for both samples. The mean common equity ratio for the Water and Utility samples equals 46.21% and 44.82%, respectively. (Staff Ex. 3.0, pp. 25-26.)

Silverleaf's December 31, 2002 capital structure contains far more debt and thus is exposed to a higher degree of financial risk than a comparable water company. The capital structures of S&P's A-rated utilities are not nearly so risky. Therefore, Ms. Kight imputed a capital structure consisting of 53.16% long-term debt and 46.84% common equity. To be consistent with the financial risk reflected in her recommended cost of common equity, the imputed capital structure for Silverleaf is based on the mean debt ratios of the Water and Utility samples. The mean long-term debt ratios for Ms. Kight's Water and Utility sample are 53.07% and 53.24%, respectively. Therefore, she used the average of the two samples' debt ratios, or 53.16%, for Silverleaf's long-term debt ratio. Since preferred stock generally composes a relatively small proportion of capital, she excluded it from the capital structure. Common equity composes the remaining 46.84% of the capital structure. Since short-term debt is not currently a source of financing for Silverleaf's rate base investments Ms. Kight did not include it in the capital structure. (Staff Ex. 3.0, p. 27.)

The Company's actual 2002 capital structure is much weaker in terms of financial strength, and more consistent with speculative-grade debt with a B rating. In comparison, Ms. Kight's cost of capital recommendation is based on the financial strength commensurate with an A+ rating. Use of Silverleaf's 2002 capital structure in determining the overall cost of capital would necessitate far higher costs of debt and equity to compensate investors for the additional risk associated with a B credit rating. The cost of B rated debt is at least 1000 basis points (10 percentage points) higher than the cost of A+ rated debt. The cost of common equity would increase as well; however, the precise amount is more difficult to determine. (Staff Ex. 3.0, pp. 28-29.)

a. Embedded Cost of Debt

Ms. Kight imputed a cost of debt for Silverleaf, which restructured all of its debt in May of 2002. The restructured debt had an average term to maturity of five years. Silverleaf's current embedded cost of debt is over 6%. The cost of 5-year A+ rated utility debt on April 2, 2003 was 3.68%. The increased cost of debt for Silverleaf is due to its higher-risk nonregulated land development and resort time shares businesses. (Staff Ex. 3.0, p. 23.)

Section 9-230 of the Illinois Public Utilities Act ("Act") states in part that:

In determining a reasonable rate of return upon investment for any public utility in any proceeding to establish rates or charges, the Commission shall not include any (i) incremental risk, (ii) increased cost of capital..., which is the direct or indirect result of the public utility's affiliation with unregulated or non-utility companies. 220 ILCS 5/9-230.)

Since Silverleaf's current embedded cost of debt is higher than comparable A+ rated utility debt due to its affiliation with unregulated or non-utility businesses, that incremental cost cannot be included in the Commission-authorized rate of return. (Staff Ex. 3.0, pp. 23-24.)

Companies typically stagger debt maturities so that a large proportion of principal is not due within a limited time period. Concentrating debt maturities within a short time frame increases both liquidity risk and interest rate risk. Therefore, rather than use an interest rate associated with a single term to maturity, Ms. Kight developed a weighted average from interest rates for debt securities with several different terms to maturity. That weighted average interest rate was calculated in three steps. First, the composition of long-term debt issuance maturities was established for a typical power

company. Next, the cost for each maturity of long-term debt was ascertained by adding the A+ utility spread to the current interest rate on Treasury securities with matching maturities. Finally, the weighted average cost of debt was determined by multiplying the weight of each maturity of long-term debt by its corresponding cost, resulting in a reasonable cost of long-term debt of 4.86% for Silverleaf. (Staff Ex. 3.0, pp. 22-23.)

b. Cost of Common Equity

Silverleaf proposed adopting a 10.0% return on common equity. (SRI Ex. 3, p. 5.) Staff witness Kight measured the investor-required rate of return on common equity for Silverleaf with the discounted cash flow (“DCF”) and risk premium models. Ms. Kight asserted that DCF and risk premium models cannot be directly applied to Silverleaf since its common stock is not market-traded. Therefore, Ms. Kight applied those models to two samples. (Staff Ex. 3.0, p. 3.) Ms. Kight testified that a firm’s market-required return on equity is a function of its operating and financial risks. Standard & Poor’s (“S&P”) business profile scores reflect the operating risk of a utility. She imputed a business profile score of 3 and a credit rating of A+ for Silverleaf, which are based on the average business profile score and credit rating of the eleven market-traded water utilities listed on S&P *Utilities & Perspectives*. (*Id.* pp. 4-5.) To form the Utility Sample, Ms. Kight selected all electric and gas distribution utilities listed in S&P *Utility Compustat* // database that had at least a credit rating of A+ and business profile score of 3. She eliminated companies that (1) lacked either Zacks Investment Research (“Zacks”) or Institutional Brokers Estimate System (“IBES”) growth rates; and (2) were in the process of being acquired by another company. To form the Water Sample, Ms. Kight included all water companies for which sufficient data to conduct DCF and risk premium analyses was available and that are not being acquired by another company. (*Id.* at 3-5.)

Ms. Kight testified that according to DCF theory, the market value of common stock equals the present value of the expected stream of future dividends. The companies in her Utility Sample and Water Sample pay dividends quarterly. Thus, Ms. Kight applied a constant growth quarterly DCF model. (Staff Ex. 3.0, p. 6.)

Ms. Kight asserted that the DCF methodology requires a growth rate that reflects investor expectations. She measured the market consensus expected growth rates with projections published by IBES and Zacks. The growth rate estimates were combined with stock prices and dividend information as of April 2, 2003. Based on this growth, stock price and dividend data, Ms. Kight's DCF analysis estimated an 11.16% return on common equity for the Utility Sample and 9.10% for the Water Sample. (Staff Ex. 3.0, p. 7-10.)

Ms. Kight testified that the risk premium model is based on the theory that the market-required rate of return for a given security equals the risk-free rate of return plus a risk premium associated with the security. She stated that the risk premium methodology is consistent with the theory that investors are risk-averse, requiring higher returns to accept greater exposure to risk. Ms. Kight used a one-factor risk premium model, the CAPM, to estimate the cost of common equity. She asserted that in the CAPM, the risk factor is market risk, which cannot be eliminated through diversification. (Staff Ex. 3.0, pp. 10-11.)

According to Staff, to implement the CAPM, one must estimate the risk-free rate of return, the expected rate of return on the market portfolio and beta. (Staff Ex. 3.0, p. 11.) Ms. Kight used the current 5.13% yield for thirty-year U.S. Treasury bond as the estimate of the risk-free rate of return. (Id. p.14.) She estimated a 14.37% expected rate

of return on the market by conducting a DCF analysis on the firms composing the S&P 500 Index. (Id. pp. 16-17.) Ms. Kight averaged the Value Line and regression beta estimates, resulting in beta estimates of 0.585 for the Utility Sample and 0.52 for the Water Sample. (Id. pp. 20.) Using these three parameters to implement the CAPM produced a 10.54% estimate of the required rate of return on common equity for the Utility Sample and 9.94% for the Water Sample. (Id.)

Ms. Kight testified that a thorough cost of common equity analysis requires both the application of financial models and the analyst's informed judgment. A cost of common equity recommendation based solely upon judgment is inappropriate. However, because cost of common equity measurement techniques necessarily employ proxies for investor expectations, judgment is necessary to evaluate the results of such analyses. Along with DCF and CAPM analyses, Ms. Kight considered the observable 6.65% rate of return the market currently requires on A-rated utility long-term debt. (Staff Ex. 3.0, pp. 20-21) Based on Ms. Kight's analysis, the investor-required rate of return on common equity for Silverleaf is 10.21%.

Ms. Kight estimated the investor-required rate of return on common equity by: 1) averaging the DCF-derived estimates of the required rate of return on common equity for the water and utility samples, or 10.18%, 2) averaging the CAPM-derived estimates of the required rate of return on common equity for the water and utility samples, or 10.24%, and 3) taking the midpoint of the DCF and CAPM derived estimates, or 10.21%. (Staff Ex. 3.0, p. 21)

C. Summary

The overall cost of capital estimate for Silverleaf is 7.36%. Ms. Kight's cost of capital recommendation of 7.36% incorporates a cost of common equity of 10.21%.

Silverleaf's overall cost of capital is summarized as follows:

<u>Component</u>	<u>Ratio</u>	<u>Cost</u>	<u>Weighted Cost</u>
Debt	53.16%	4.86%	2.58%
Common Equity	<u>46.84%</u>	10.21%	<u>4.78%</u>
Total	100.00%		7.36%

VI. RATE DESIGN

A. Recommended Rates

If the Commission finds that SRI is a public utility, the Commission should approve SRI's proposed rates and billing for water and sewer service to two-customers (Silverleaf Club and Fox River Sales and Member Services) at the Fox River Resort. Mr. Marr adopted SRI's proposal to charge \$57.11 per connection per month for water service, and \$152.55 per connection per month for sewer service. (See Staff Ex. 4.01 for the rate schedules for water and sewer service to the Fox River Resort). These proposed rates factor a total of 219 connections for water and sewer service at the Fox River Resort into Staff's proposed revenue requirement. Mr. Marr adopted SRI's proposal to separately bill Silverleaf Club and Fox River Sales and Member Services on a monthly basis for water and sewer service at the Fox River Resort.

Fox River Resort has a total of 219 connections for water and sewer service. There are 186 service connections to the timeshare units, 6 service connections to the RV campsites, 18 service connections to the cabins, 2 service connections to the sales and member services buildings, 3 service connections to the housekeeping department

coin operated washing machines and restrooms, 1 service connection to the registration restroom, 2 service connections to the swimming pools, and 1 service connection to the picnic area restroom. Fox River Sales and Member Services should be responsible for 2 service connections to the sales and member services buildings at the Fox River Resort where the sale of timeshare units takes place and where tours of the premises are arranged. Silverleaf Club should be responsible for the remaining 217 service connections for water and sewer service at the Fox River Resort. (Staff Ex. 4.00, pp. 2, 10-13, 34; Staff Ex. 5.00, pp. 1-2)

SRI and the Commission Staff have reached agreement on the rates derived from Staff's recommended revenue requirement. (SRI Ex. 8, pp. 3, 6, 10, 11) The proposal provides that SRI will bill two customers, Silverleaf Club and Fox River Sales and Member Services, for water and sewer service at the Fox River Resort.² Under this proposal, the timeshare members will not receive monthly bills for water or sewer service. (SRI Ex. 1, p. 13) The rates were designed by dividing the revenue requirement calculated by Staff by the total number of service connections. This is the same rate design and two-customer billing structure as used at the Texas and Missouri resorts.³ (Staff Ex. 4.00, pp. 28-29; Staff Ex. 5.00, p. 3)

This methodology is the most efficient design for SRI for a number of reasons. First and foremost, the SRI utility billing system does not interface with the Silverleaf

² Initially, Staff Witness Marr disagreed with SRI regarding the total number of service connections and with SRI's proposed customers of Silverleaf Club and Fox River Sales and Member Services for water and sewer service at the Fox River Resort (Staff Ex. 2.00, p. 24) and recommended that the customers, Fox River Resort timeshare owner and each Fox River Sales and Member Services building, be billed separately for water and sewer service at the Fox River Resort. (Staff Ex. 2.00, pp. 28-31) The argument in this Brief reflects in Mr. Marr's rebuttal and supplemental rebuttal testimony.

³ With the except that there are no proposed usage charges for the Fox River Resort. Here, costs and rates are not allocated based on usage because none of the service connections at the Fox River Resort are currently individually metered. (Staff Ex. 2.00 at 19-20; Staff Ex. 4.00, pp. 11; 33-34; Staff Ex. 5.00 at 3)

Club timeshare reservation system, the Silverleaf Club timeshare membership dues billing and collection system, or the SRI timeshare sales and collection system. This makes it difficult and infeasible to track individual Fox River Resort timeshare owners for purposes of utility service billing. Tracking individual customers would be necessary in order to bill customers individually. The number of timeshare owners and users at Fox River Resort, and other SRI resorts, is constantly changing. This is due to sales of timeshares, variability of the actual use of timeshares, the day usage, the Exchange, and Bonus Time Programs. Given the extensive movement of patrons, and given the manner in which Silverleaf Club budgets and sets membership dues, it would be extremely difficult to track and bill Fox River Resort timeshare owners for the direct costs of operating the Fox River Resort, such as the cost of water and sewer service. In order to track individual customers, SRI would need to make expensive changes to its utility billing system with limited benefits. (Staff Ex. 4.00, pp. 20-26)

There are other complications associated with billing individual timeshare owners. Under the timeshare owner's sales contract with SRI, utility service is included in the purchase of a timeshare unit and the payment of monthly membership dues. (SRI Ex. 4, Sch. ELL-1, p. 3, #9) Thus timeshare owners may object to being billed for the utility services separately. (Staff Ex. 4.00, pp. 17-19)

Requiring SRI to bill individual timeshare owners for utility service would have a detrimental affect on Illinois timeshare owners. Given the way in which SRI operates all of its resorts, if SRI is ordered to directly bill Fox River Resort timeshare owners for utility services, only those purchasing timeshare units at Fox River Resort will be bearing water and sewer costs. Timeshare owners visiting from other SRI resorts would not be billed. Fox River Resort timeshare owners would continue to be billed for utility

service at the Fox River Resort even if they chose to stay at another SRI resort. This result is inequitable because the cost causers are not necessarily those who pay for the cost. Direct billing of individual Fox River Resort timeshare owners for utility services could encourage timeshare owners to purchase timeshares at SRI resorts other than Fox River Resort so as to avoid the additional cost arising from utility bills. (Staff Ex. 4.00, pp. 20-22)

Collection of past-due utility bills from individual Fox River Resort timeshare owners would pose a problem for SRI. Disconnection of service cannot be used as a means to collect past-due utility bills. The physical configuration of the plumbing at Fox River Resort, the variability of usage, and the one-week usage period of the timeshares all combine to make disconnection impracticable. Because the timeshare sales contract provides that utility service is included in the purchase of a timeshare unit and the payment of monthly membership dues, if a timeshare owner pays their monthly membership dues, they cannot be denied access to their timeshare unit as a means to collect past-due utility bills. (Staff Ex. 4.00, pp. 26-27)

The recommendation for customers and rates is consistent with the characteristics of the timeshare resort. For purposes of utility service, a timeshare resort is more akin to a hotel. Since SRI's service demands are generated like a hotel's, SRI should be treated like a hotel for purposes of defining customer classes of utility service for rate design purposes. Because Fox River Resort timeshare owners, like hotel patrons, do not occupy their timeshare units year round, they should not be directly billed for utility service. It is the hotel (or its management company) that is directly billed for utility services, instead of the individual guests. Like a hotel, Silverleaf

Club should provide accommodations to a timeshare owner with no separate charge for utility services. (Staff Ex. 4.00, pp. 29-30)

B. Alternate Individual Billing Proposed Rates

In the event that the Commission determines that SRI is a public utility and does not adopt the agreed to rate design discussed above, Staff provided alternative rates for individual billing of Fox River Resort timeshare owners, Thousand Trails members, and Fox River Sales and Member Services buildings. SRI has objected to and criticized the concept of direct billing timeshare owners for water and sewer service at Fox River Resort contained in this alternative rate proposal. (SRI Ex. 8, pp. 3, 9, 11) This is not Staff's preferred rate design, but Staff has provided this alternative in the event the Commission orders individual billing.

To calculate water and sewer rates for this alternative method, Staff Witness Marr divided Staff's recommended revenue requirement by 206 total service connections. For water service, Staff witness Marr proposed that SRI charge \$2.00 per connection per day to each individual Thousand Trails member, \$14.01 per connection per week to each individual Fox River Resort timeshare owner, and \$60.71 per connection per month to each individual Fox River Sales and Member Services building. For sewer service, Mr. Marr proposed that SRI charge \$5.33 per connection per day to each individual Thousand Trails member, \$37.43 per connection per week to each individual Fox River Resort timeshare owner, and \$162.18 per connection per month to each individual Fox River Sales and Member Services building. (Staff Ex. 4.00, p. 30)

Under this alternative, SRI would directly bill, on a monthly basis, each individual daily Thousand Trails member, each individual weekly Fox River Resort timeshare

owner, and each individual Fox River Sales and Member Services building for water and sewer service at the Fox River Resort. (Staff Ex. 4.00, pp. 2, 30-32, 34-35)

Staff Witness Marr determined the total number of service connections at the Fox River Resort for water and sewer service to be 206. At the end of year 2002, there were 186 service connections to the timeshare units, 2 service connections to the sales and member services buildings, and 18 service connections to the cabins, for a total of 206 service connections. Mr. Marr determined that there are basically three groups of customers (Fox River Resort timeshare owners, Thousand Trails members, and Fox River Sales and Member Services) that are allowed to use the water and sewer services at the Fox River Resort. SRI is responsible for the sales and member services building. The timeshare units (186 weekly service connections) may only be used by the Fox River Resort timeshare owners and the cabins (18 daily⁴ service connections) may only be used by the Thousand Trails members. The Fox River Resort timeshare owners and the Thousand Trails members are allowed to use common amenities.

The difference in the number of service connections for this alternative as compared to the agreed to proposal, 206 as compared to 219, is due to the 13 service connections to the common amenities. Rather than the common amenities being treated as separate service connections, the cost of service to the common amenities is spread across the Fox River Resort timeshare owners and the Thousand Trails members. These costs are not directly allocated to the cost causers because it would be too difficult for the SRI Utility Department to keep track of each amenity and service that each Fox River Resort timeshare owner and Thousand Trails member uses.

The problem with the individual billing approach is the difficulty, as discussed above, in

⁴ Thousand Trails members rent cabins nightly, so daily rates were calculated.

directly allocating the costs of utility service to the service connections and to the customers who use them. In addition, water usage cannot be used as a means of allocating costs because none of the service connections at the Fox River Resort are metered. Individual billing is disadvantageous to the Fox River Resort timeshare owner because other Silverleaf Club members from other SRI resorts are also allowed to use the Fox River Resort under the Bonus Time and Exchange Programs. (Staff Ex. 4.00, pp. 32-34)

VII TARIFF TERMS AND CONDITIONS

A. Proposed Tariffs

Staff's proposed tariffs for water and sewer service to the Fox River Resort would apply to two-customers: Silverleaf Club and Fox River Sales and Member Services. The tariffs define the Customer as the party contracting for water and/or sewer service. (Staff Ex. 5.00, p. 4)

If the Commission finds that SRI is a public utility, the Commission should not approve SRI's proposed tariffs for water and sewer service to the Fox River Resort because SRI's proposed tariffs are in contradiction of Commission rules and regulations and Staff's proposed tariffs. (Staff Ex. 2.00, pp. 10-18; Staff Ex. 5.00, pp. 4-5) Staff's proposed tariffs were designed to comply with the Commission's regulations. (Staff Ex. 5.00, p. 5) Mr. Marr recommended that the Commission approve Staff's proposed Rules, Regulations, and Conditions of Service Tariffs, as included in Staff Ex. 2.01 and 2.02. (Staff Ex. 2.00, p. 18; Staff Ex. 4.00, pp. 11-12; Staff Ex. 5.00, p. 5) These tariffs were compiled previously by Staff, provided to other Illinois regulated utilities, and approved by the Commission in several different docketed proceedings, most recently

in Docket No. 02-0592 for Del Mar Water Company. (Staff Ex. 2.00, p. 18; Staff Ex. 5.00, p. 5)

Staff Witness Marr recommended that the Commission Order SRI to file the Rates, Rules, Regulations, and Conditions of Service Tariffs, as included in Staff Ex. 2.01, 2.02, and 4.01, within 30 days of the final Order, with an effective date of not less than 30 working days after the date of filing, for service rendered on and after their effective date, with individual tariff sheets to be corrected within that time period, if necessary. (Staff Ex. 2.00, p. 34; Staff Ex. 4.00, pp. 11-12)

SRI agreed to accept Staff Witness Marr's entire proposed tariffs in lieu of the Company's proposed tariffs. (SRI Ex. 4, p. 13-14; Staff Ex. 5.00 at 5; SRI Ex. 8, p. 10)

B. Waiver of Water Meter Requirements

None of the service connections at the Fox River Resort are currently metered. SRI requested a waiver of the water meter requirements of 83 Ill. Adm. Code 600.260. (Amended Petition, p. 5)

If the Commission finds that SRI is a public utility, Staff Witness Marr recommended that the Commission approve a waiver of the water meter requirements of 83 Ill. Adm. Code 600.260. (Staff Ex. 2.00, p. 21) However, Mr. Marr also recommended that the Commission require a master meter to be installed to measure all water usage to the Fox River Resort, and also require a down stream meter to be installed to measure water usage to the sales buildings. (Staff Ex. 2.00, pp. 21-22; Staff Ex. 5.00, p. 4) The water usage on the master meter, less the water usage on the sales buildings meter, would determine the water usage of the Silverleaf Club. (Staff Ex. 2.00, p.; Staff Ex. 5.00, p. 4) This manner of metering best matches the existing

plumbing configuration of the Fox River Resort. (Staff Ex. 2.00, p. 22; Staff Ex. 5.00, p. 4) As a result of this required metering, Staff could design rates based on usage in a future rate case. (Staff Ex. 5.00, p. 4)

Staff Witness Marr recommended that the Commission require the water meters be installed at the Fox River Resort within 6 months of the date of the Order. The Company agreed. (Tr. not final at preparation of initial brief)

VIII. CONCLUSION

For the reasons set forth above, the Staff of the Illinois Commerce Commission respectfully requests that the Commission order reflect Staff's recommendations.

February 25, 2004

Respectfully submitted,

JANIS VON QUALEN
Staff Attorneys

Counsel for the Staff of the
Illinois Commerce Commission

JANIS E. VON QUALEN
Office of General Counsel
Illinois Commerce Commission
527 East Capitol Avenue
Springfield, IL 62701
Phone: (217)785-3402
Fax: (217)524-8928